Backgrounder

GOODS AND SERVICES TAX: REVIEW OF THE HOUSE OF COMMONS FINANCE COMMITTEE REPORT

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INTRODUCTION

On 8 August 1989, the Department of Finance published a long-awaited technical paper on the Goods and Services Tax (GST). The paper proposed replacing the Federal Sales Tax (FST) with a value-added type of tax at a rate of 9% on a wide range of goods and services. There have been calls for reform of the seriously flawed FST for over 50 years. Among other things, it has been said that the FST discriminates against our exports and favours imports, that it skews consumers' choices by distorting relative prices -- since many goods and services are not taxed --, that it is a regressive tax, that producers' decisions are biased because many business inputs are not taxed, that it is complex and difficult to comply with and that it is an unreliable source of government revenues.

The House of Commons Finance Committee tabled an extensive report on the subject of the GST on 27 November 1989, after hearing 274 witnesses and receiving close to 1,500 submissions. This brief overview of the over 300-page report examines the Committee's principal recommendations and the major issues dealt with. Because it is assumed that most parliamentarians will be interested only in the essentials, some highly technical issues and accounting details found in the report (e.g. transition measures, filing requirements) or issues considered less important (i.e. passenger transportation services, lotteries, used goods) will not be discussed.

APPROACHES TO SALES TAX REFORM

The Committee agrees that the existing FST should be abolished because it is seriously flawed. Of the three immediate possible options (increase in income taxes, a federal retail sales tax or a value-added tax (VAT)), the Committee prefers a broadly based VAT. It believes that a consumption tax favours saving, investments and economic growth. A value-added type of tax is preferred to a federal retail sales tax; though the latter is easier to administer and comply with, a VAT has the advantages of making evasion more difficult and of being more effective in exempting business inputs from taxation.

GST benefits would have three sources: 1) a reduction in the variation of effective tax rates across commodities; 2) the elimination of the tax burden on business inputs leading to increased capital accumulation; and 3) improvement in the international competitiveness of Canadian producers.

The Committee believes that a jointly operated National Sales Tax (NST) would solve the complexity and the cascading effects of having both a federal GST and provincial retail sales taxes. It recognizes however that provinces are most likely to join the federal government one at a time, rather than all at once. Therefore the Committee recommends that the federal government establish the NST on a partial basis as soon as three or four provinces with a substantial population are prepared to take part.

ECONOMIC AND DISTRIBUTION ASPECTS

The Committee proposes an alternative GST package, which would have fiscal and price implications. Basically it would lower the proposed general rate from 9% to 7% and tax real estate trade-ups at a rate of 5%.

The measures proposed by the Committee are expected to generate $20.9 billion in 1991, net of the small business administration fee and rebates to the MUSH (municipalities, universities, schools and

hospitals) and non-profit sectors. It is estimated that the proposed modified small business administration fee (equal to 5% of the registrant's GST net liability to a maximum of $600 annually) would cost $300 million a year. The revenue losses of approximately $5.0 billion from the reduction of the general GST rate to 7% from 9% would be made up through the expansion of the tax base by the taxation of real estate trade-ups ($1.6 billion).

Increased excise taxes on alcohol and tobacco ($0.5 billion) would recapture the revenues lost from substituting the 19% FST with a 7% GST. Expenditures would be lowered by the withdrawal of the middle income tax reduction ($0.7 billion), while GST credit and indexation costs ($2.2 billion) would be reduced in proportion to the lightening of the GST tax burden on lower income households.

FISCAL IMPACT OF 7% GST
($ billion)

Revenues		Expenditures	
GST at a 7% general rate and 5% for real estate transactions (Technical Paper base)	18.8	FST	18.5
Real Estate base expansion	1.6	GST credit	1.2
Alcohol and Tobacco	0.5	Indexation	1.0
		Administration	0.2
Total	20.9		20.9

The amounts for the GST credits have been set as follows: $250 for the first adult in the household, $175 for the second adult and $100 per child. Because of the lower rate of 7% proposed by the Committee, the burden on consumers would be lower, thus reducing the need for GST credits. Furthermore, the Committee recommends that the single person's credit be eliminated. This would allow for a higher basic GST credit for the first adult in any household.

The Committee recommends that extra revenues that might be generated by the sales tax reform (i.e. through the fiscal feedback from the impact of the package on the economy, and lower indexation costs in the long run from lower inflation) should be used to reduce the government deficit and not be diverted to new program spending. Because of the 2.25%

price increase expected from the government's proposed GST, the Committee thinks there is danger of a price-wage spiral. This could have an enormous effect on the economic well-being of Canadians. The Committee's package, which sets the tax at 7%, would increase the CPI by only about one percentage point; reducing the danger of a price wage spiral would ease the transition to tax reform and would substantially reduce the short-term adjustment costs.

THE DESIGN OF THE GST

A. Defining the Tax Base (Chapter C-3 in the Finance Committee report)

The Committee endorses the Technical Paper (TP) conclusion that basic groceries be zero-rated, despite the higher tax rate and the complexity this would bring to the GST. Furthermore, it agrees with option 1, under which the tax status of food would be based on the nature of the establishment that sold it. Among other things, the Committee endorses the government proposal for zero-rate agricultural and fish products, prescription drugs and medical devices. Concerning tax-exempt supplies, the Committee agrees with the TP proposal to exempt institutional health care and health care practitioners and also believes that diagnostic psychological services provided on a non-elective basis should be tax-exempt. As proposed in the TP, educational and day care services should also be exempt. The Committee recommends that all provincially-licensed commercial day care services be entitled to a rebate of 50% of all GST paid. This would ensure equal treatment of commercially-operated day care and not-for-profit and charitable day care. In order to simplify the operation of the GST for lawyers providing legal aid services, the Committee recommends that legal aid services be made fully taxable but that a rebate of tax be paid to all provincial legal aid societies.

B. The GST and Small Business (Chapter C-4)

The Committee recognizes that small businesses are concerned that they would face disproportionately high compliance costs. It

concluded, however, that a fee for collection would be more appropriate than a fee for compliance. The collection fee should be equal to the lesser of $600 or 5% of the net remittance of the registrant. This small business administration fee, as stated in the TP, should be available only to registrants who are carrying on a business and have revenues from taxable and zero-rated supplies of $2 million or less. Concerning the proposed streamlined accounting methods, the Committee suggests that the government should consider the use of general simplification methods for various types of small businesses instead of just for registrants selling a combination of taxable and zero-rated food products at the retail level. For example, the government should consider simplifying procedures for small businesses with income between the $30,000 exemption limit and $500,000. The small business administration fee should not be payable to firms using these simplified accounting methods. Among other simplified methods, the Committee recommends a reduced rate option similar to that in Japan, a de minimus rule similar to that in Japan and special rules for direct sellers.

C. Transportation and Travel (Chapter C-6)

The Committee believes that although short-term adjustments in tourism might take place because of the GST, in the long run the tourism industry would gain as a result of the increase in Canadians' disposable real income; the transitional difficulties should not be viewed as permanent. The Committee recommends that the foreign tourist rebate be visible and simple to claim. Concerning the tax treatment of freight transportation services, the Committee recognizes that the GST could potentially increase the cost of transporting finished products consumed far from the point of production. This inflationary effect in regions remote from production and distribution centres, however, would be offset by a reduction in the price of zero-rated products and in the cost of transporting business inputs. The Committee recommends that once its financial position is more balanced, the government should consider integrating the excise tax on fuel into the GST through the input tax

credit system, in order to eliminate the distortions associated with the excise tax.

D. Real Property (Chapter C-7)

Because the TP proposal relating to housing could seriously distort the housing market -- by discriminating between new and old houses, rented and owner-occupied, moderately priced and expensive -- the Committee believes it would be preferable to include all property transactions in the tax base and apply lower tax rates than are proposed. Instead of the government's 9% tax on new ownership and on rental housing -- a proposal by which an average GST of 6.9% would be levied -- the Committee proposes to tax all non-commercial real estate trade-ups (i.e. any net increase in the value of real estate acquired by a purchaser) at 5%. This should apply to new and existing housing, new and existing personal use properties, and new and existing residential rental properties; it would exclude transfers between related individuals of land used for farming purposes. As an example, a person who sold his or her principal property for $100,000 and acquired another property for $150,000 would be taxed at 5% on the $50,000 trade-up. Commercial properties would be taxed at 7% but, in accordance with the general rules, the purchaser would be entitled to an input tax credit for the tax paid.

E. Charities and Non-Profit Organizations (Chapter C-8)

The Committee endorses the proposed rebate of 50% for charities and non-profit organizations, since it appears to be adequate to maintain or improve their tax position relative to the existing FST. The Committee believes, however, that the government should carry out additional research to ensure that the overall tax burden on this sector would not increase. Furthermore, the Committee believes that non-profit organizations should be eligible to receive a 50% rebate of the GST paid on their purchases if they are 25% or more funded by the government in a given year, (not 50% as proposed in the TP). The 50% rebate should be reduced by one-fifth for each percentage point that an organization's funding from

government fell below 25% of its revenues. Concerning the arts community, even though the Committee agrees that the cost of admission to arts events should be taxed, it recognizes that certain organizations would be required to raise ticket costs or increase other sources of revenue in order to meet their new obligations under the GST. Therefore the federal government should make special grants to the Canada Council and other agencies supporting the arts to offset any serious problems created through the introduction of the GST.

F. The Public Sector (Chapter C-9)

The Committee believes, like the government, that the GST should not increase the current sales tax burden of the MUSH sector (i.e. municipalities, universities, schools and hospitals). The TP proposes to use four rebate rates (one for each sector) so that the GST liability net of rebates would not be greater than the existing FST. The Committee believes that, since it is a very complex and difficult exercise to calculate the actual FST burden for each sector, the Department of Finance should proceed immediately to determine and negotiate the four rebate rates for the MUSH sectors in close consultation with the affected institutions. Furthermore, the government should work with MUSH institutions to develop a streamlined accounting system that would simplify their calculation of the net amount of GST payable on their taxable supplies.

G. Indians and Indian Bands (Chapter C-10)

Under Section 87 of the Indian Act, Indians are exempt from federal taxation on their personal property situated on a reserve. Like the TP, the Finance Committee does not make any precise recommendation on this subject. It limits itself to summarizing representations made by witnesses and the problems that would be encountered if an exemption certificate proving status as a registered Indian were used to allow vendors to waive the collection of the GST.

H. Financial Services (Chapter C-11)

Because of the difficulty in taxing financial intermediation services -- primarily offered by banks, trust companies, insurers, financial cooperatives and investment dealers -- the TP proposes to exempt the supply of financial services to consumers and businesses and to zero-rate exported financial services. The Committee agrees with this proposal. Furthermore the Committee agrees that the term "financial institution" be extended not only to regulated entities but also to persons whose principal business is providing financial services. The TP proposes a de minimus rule -- a person's income from interests and dividends must exceed 10% or $10,000,000 of total income from a business -- for that person to be defined as a financial institution. The Committee, however, believes that the term "financial institution" should be defined so as to include only persons who can be regarded as direct competitors with financial institutions in supplying financial services. Therefore the Committee recommends that the 10% rule be rescinded and that a revenue test be applied only to firms with annual revenues from interest and dividends which exceed $10 million. Like the TP, the Committee proposes no group relief for inter-company transactions within a related group of companies. However, the Committee recommends that special group relief to certain named corporations be granted for specified types of transactions (i.e. data processing, management). For transactions between credit unions and caisses populaires, the Committee recommends that equivalent special group relief be provided where there is comparable relief for other financial institutions and related companies.